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CHALLENGES OF CONVERTING NONPROFIT IN FOR-PROFIT - REASONS,  
DECISION MAKING AND KEY SUCCESS FACTORS OF A CONVERSION

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## CHALLENGES OF CONVERTING NONPROFIT IN FOR-PROFIT - REASONS, DECISION-MAKING AND KEY SUCCESS FACTORS OF A CONVERSION

### Abstract

Due to external constraints (opposed by the market and legal system) and internal changes nonprofit organizations have been converting to for-profit entities combining commercial revenue and social value creation. To create an understanding of the conversion process considering its challenges, the reasons, the decision-making process and key success factors of a conversion are examined. Therefore, a two-step research procedure is used combining literature research and a multiple case study approach based on expert interviews with known companies. The outcome is a helpful guideline (including a decision matrix) for social entrepreneurs that might face a conversion.

### Tag words:

*Nonprofit/For-Profit Conversion, Conversion Decision-Making, Conversion Challenges, Conversion Key Success Factors*

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**List of Abbreviations**

B-Corporation / B-Corp	Benefit corporation
FPO	For-profit Organization
HMO	Health maintenance organization
L3C	Low-profit limited liability company
LLC	Limited liability company
MFI	Microfinance institution
NPO	Nonprofit Organization
ROI	Return on Investment

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## 1 Introduction

For more than a century, the assumption of independence between commercial revenue and social value creation has been valid. Today it is clear that nonprofit organizations (NPO)<sup>1</sup> and for-profit organizations (FPO)<sup>2</sup> can reinforce each other. However, the recent financial crisis was a showcase for social costs resulting from corporate profit-seeking activities (Battiliana et al. 2012). Apart from direct consequences like unemployment, indirect implications (e.g., public spending cuts) lead to the constraint of competitive arrangements for nonprofits. In addition, FPOs are increasingly incorporating classic nonprofit elements that force NPOs to find new ways of generating value and to implement for-profit characteristics (Thieme & Winkelhake 2012). Hence, nonprofits have already been converting to for-profits due to the increase and speed of external changes that lead to the opportunity to change the organizational model to for-profit (Goddeeris & Weisbrod 1998, 2006). However, to create social benefit while seeking profit is a great challenge and might cause mission drift that defeats the original charitable purpose but may also create conflicts of interest and diversion of public resources to private gains (Battiliana et al. 2012, Jäger & Schröer 2014).

Therefore, the research topic of this work project is to create an understanding of the reasons, decision-making and key success factors (KSF) of a nonprofit to for-profit conversion considering its challenges. To study this, a combined two-step research process is used. The literature review in chapter 2 serves as the first step. It helps to obtain already available knowledge and to identify research gaps that will define the research questions. The methodology in chapter 3 describes the scientific procedure of

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<sup>1</sup> Synonym for nonprofit organization (NPO) is nonprofit.

<sup>2</sup> Synonym for for-profit organization (FPO) is for-profit.

the second step: The analysis of expert interviews with managers of selected companies that went through a conversion and serve as a reference in the market will complement and validate the literature in chapter 4. In chapter 5 the implications derived from literature and primary research have the main goal to create economic and social value in form of a practical guideline for social entrepreneurs and nonprofit managers who might face a conversion. In addition, it is the objective of this work project to create scientific value by exploring a gap in the current research situation and thereby delivering ideas for future research.

## 2 Literature Review

It is important to mention that most of the relevant scientific literature in English originates in the US. Therefore, regional characteristics may apply.

### 2.1 Nonprofit, For-Profit and in Between

Nonprofits<sup>3</sup> are “(a) organizations; that (b) are not-for-profit and, by law or custom, do not distribute any surplus they may generate to those who own or control them; (c) are institutionally separate from government; (d) are self-governing; and (e) are non-compulsory [...] (United Nations 2003:16)<sup>4</sup>.” Although non-governmental as well, a corporation or FPO respectively differs from a NPO in that way that it is “set up for purposes of engaging market production and [is] capable of generating a profit or other financial gain for their owners (United Nations 2003:13).” Even though, both business structures strive for making profits, the main difference<sup>5</sup> is the non-distribution

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<sup>3</sup> Nonprofits operate in the nonprofit sector, also third sector. It describes market entities or institutions amongst the public (state) and the private (households and corporations) sector (Hudson 2009).

<sup>4</sup> See United Nations (2003). The definition of the sector and its implications are derived from John Hopkins Comparative Non-Profit Sector Project (Salamon & Anheier 1997) and the System of National Accounts, 1993 (Commission of the European Communities et al. 1993). This structural/operational definition is recommended to work best compared to others especially for cross-national research (Salamon & Anheier 1992).

<sup>5</sup> There are eight distinct features that give nonprofits production functions and characteristics, which

constraint, i.e., that a nonprofit may be profitmaking but it is non-profit distributing (Koning et al. 2007, United Nations 2003). Thereby, Bromberger (2011) and Battiliana et al. (2012) argue that the primary objective of a nonprofit is the accomplishment of a social or public mission while the for-profit management has the duty of maximizing shareholder return. This leads to different legal consequences as well: NPOs generally don't have access to capital through private investors or businesses, i.e., funding is dependent on donations, grants and subsidies. For FPOs it is usually the opposite. E.g., in 2011 US law did not recognize a legal entity that simultaneously accepts donation, invested capital or quasi-invested capital (Battiliana et al. 2012, Bromberger 2011). However, these consequences are only true for pure versions of NPOs and FPOs. To give a complete picture of the spectrum it is important to mention hybrid structures that fill in between both extremes and combine several funding sources. They are the result of intrepid entrepreneurs who have found ways to combine the best of both worlds despite of the separation between both sectors through regulating authorities. Social Businesses<sup>6</sup>, which legally can be nonprofit or for-profit, are to mention as well as new organizational forms like the benefit corporation (B-Corporation)<sup>7</sup>. To conclude, not only pure for-profits but also hybrid forms might be an outcome of a conversion process, which will be explained in the following.

## 2.2 Definition and Types of Nonprofit to For-Profit Conversion

Goddeeris & Weisbrod (1998) wrote one of the most complete descriptions about

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differ significantly from entities within the corporate or government sector. Only the most important is highlighted (United Nations 2003).

<sup>6</sup> A Social Business is not defined to be a NPO or FPO but it is a non-loss, non-dividend company devoted to solving a social problem. Profits are reinvested (Yunus 2011).

<sup>7</sup> From 2010 until now 29 states have passed legislation allowing benefit corporations. The US legal entity benefit corporation or B-Corporation is not be confused with the B-Corporation Certificate which is handed out by the nonprofit B-Lab that certifies for-profit companies according to their social and environmental performance. However, B-Lab is a responsible advocate for the legal progress made regarding B-Corporations (B-Lab 2015).

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nonprofit conversion and provide the most accurate definition, which will be used in this work project. For them, a nonprofit to for-profit conversion is (a) the transfer of or change in control over core nonprofit assets or responsibility for liabilities from the nonprofit to the for-profit sector and (b) a matter of degree. They distinguish six conversion types<sup>8</sup>:

1. Full conversion: Assets of the nonprofit entity are significantly transferred to for-profit control, i.e., the nonprofit ceases to exist in its previous form and is reorganized as a for-profit firm.
2. Joint venture: The control over core assets is shifted to the for-profit.
3. Partial buyout: Giving up control by selling assets for a ‘fair market value’.
4. For-profit subsidiary: Passive investment in a private firm that involves converting assets.
5. Complex interorganization contracts: The nonprofit transfers control to a private firm for a finite period of time implying contractual constraints.
6. Change of nonprofit legal form: The change in organizational form from charitable nonprofit to, e.g., mutual benefit corporation or L3C.

### **2.3 Recent Conversion History**

Taking a brief look at recent conversion history two industries stand out: The US health care market and the global microfinance sector.

Under the US HMO (health maintenance organization) act from 1973 only nonprofit firms were eligible for federal subsidies accounting for 82% of the overall industry in 1981. When direct subsidies ended in the early 1980s the share of nonprofit HMOs dropped down significantly to 29% in 1995. Also, in 1994 and 1995 92 hospitals

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<sup>8</sup> See Goddeeris & Weisbrod (1998).



converted and more than a 100 conversions occurred within the industry between 1995 and 2002 (Goddeeris & Weisbrod 1998, 2006).

The microfinance sector saw a commercialisation starting in the early 1990s followed by a transformation phase starting in 2000 (Srncic et al. 2008). Since industry metrics are easy to measure, mission drift has been a controversial research topic in this context: Even though Mersland & Strøm (2010) could not find confirming evidence studying 379 microfinance institutions (MFI) from 74 countries over a period of eleven years, mission drift could be confirmed by Chahine & Tannir (2010) examining 68 nonprofits globally that converted to non-bank MFIs or banks between 1997-2005.

Since these two conversion areas were subject to intensive research there is a high quantity of literature available in each domain. This explains why most of the literature used in this work project originates from there.

## **2.4 Reasons and Motivation of Conversion**

Determining the motivation of conversions “*requires asking why the nonprofit form was chosen initially, and then what changed to make that form less desirable (Goddeeris & Weisbrod 1998:219).*” Thus, to understand the reasons it is crucial to understand when a nonprofit or a for-profit respectively is best at the stage of foundation. For Goddeeris & Weisbrod (1998) this is given whenever advantages of the particular organizational form are overcoming constraints (opposed by the market or the legal system) relatively better to attain the founders’ goals. Battiliana et al. (2012) show that the competitive advantages of NPOs are tax benefits as well as social legitimacy and goodwill that attract grants, donations, volunteers and other inexpensive resources. Thieme & Winkelhake (2012) confirm these advantages and see FPOs biggest competitive advantage in efficiency. Goddeeris & Weisbrod (1998) confirm tax benefits

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on the nonprofit side and also add the greater access to capital and managers' private compensation to the list of for-profit advantages. Chhabra (2013) complements the FPO side by saying that for-profits have more time for value creation since no fundraising is required at a frequent level. For a complete overview of NPO/FPO advantages see Appendix 1.

Typical advantages of NPOs allow pursuing a social mission, i.e., serving beneficiaries with no or a low ability to pay since donors or volunteers don't expect a return on investment (ROI). Consequently, after the foundation external changes (changes in constraints by market opportunities or the legal system) or internal changes (in regards of managerial goals and strategy or operational bottlenecks) that affect the NPO can be the cause of conversion (Goddeeris & Weisbrod 1998). In case of a nonprofit to for-profit conversion these changes (Appendix 2 lists all changes in detail) may reduce the initial advantages the NPO has and strengthen advantages a FPO would offer to the degree that a for-profit structure becomes better to achieve the organizations' mission.

If changes in managerial goals are absent, social entrepreneur Saul Garlick argues that the nonprofit/for-profit debate is only about structure. It offers different models for how people prioritize their time, i.e., focusing more on fundraising (nonprofit) or more on developing the product further (for-profit) (Chhabra 2013a). Considering this, a conversion out of necessity due to external changes or operational bottlenecks may not automatically lead to changing the legal structure to become profit seeking but to readapt to the environment or context and pursue the social mission. However, this is contrary to the opinion that a conversion outcome leads to mission drift and a conversion out of necessity is no guarantee that the social mission won't change.

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## 2.5 Conversion Challenges

In the context of a conversion process Goddeeris & Weisbrod (2006) name challenges in the legal area (lack of private ownership of the nonprofit and legal constraints opposed by the regulator) as well as the difficulty of having different objectives (social mission vs. profit maximizing). Battiliana et al. (2012) mentions four challenges of hybrid structures that can be applied to a converted nonprofit that acts commercial but pursues a social mission:

1. Legal structure: Complex design requirements may become a burden for the management but in the recent past new legal forms like L3C or B-Corporation have been emerging that could simplify the process through clear legal requirements.
2. Financing: The pathway to private market funding is not clear and traditional investors are not used to quantify the risk of a social venture. The future may be impact investors who are becoming more important and embrace the social values.
3. Customers and beneficiaries: Hybrids combine both revenue and social value and thus, customers and beneficiaries may become indistinguishable. If the integration is not possible in one transaction a common way is to sustain the nonprofit with commercial activities. This resolves the tension between mission and growth but is thereby also subject to the risk of mission drift when priority is given to profit seeking instead of pursuing the social mission.
4. Organizational culture and talent development: To keep the mission a talented workforce is crucial. Since most people are not used to a hybrid environment hiring somebody is mostly a decision of either or. While employing people from one sector bears less conflict it might increase the risk of mission drift (if FPO experience) or not enough commercial experience (if NPO experience). People from different

sectors however, increase the likelihood of organizational conflict.

## 2.6 Key Areas to Be Understood

Following the findings of the literature review a nonprofit to for-profit conversion is understood as a process which is induced by reasons for conversion and divided into two steps: (1) The decision-making process that covers everything until the decision is made to convert to a certain organizational type and (2) the actual transformation process that consists of actions like planning (e.g., planning legal steps), implementing (e.g., changing the legal structure) and controlling the conversion (e.g., making sure that legal requirements are fulfilled). Figure 1 describes the connection.

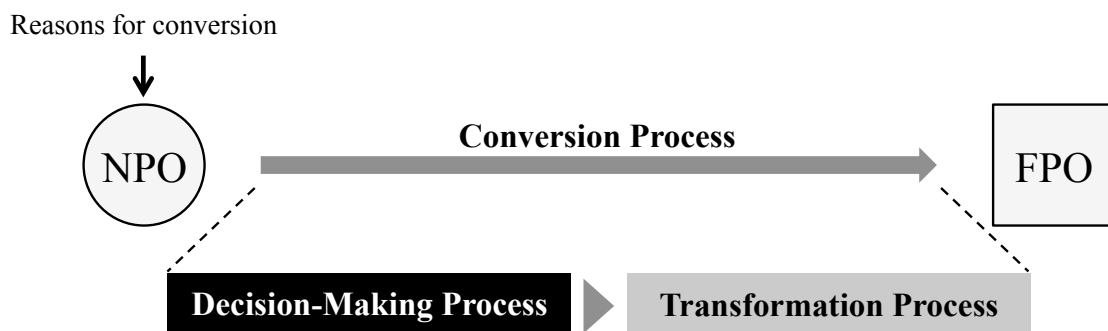


Figure 1: The schematic conversion process<sup>9</sup>

Hence, on the basis of these preliminary findings four key areas and related research questions have emerged to fill the gap of missing knowledge and to get a comprehensive and more complete view on the topic:

- I. Historical development of the NPO until conversion: Based on Goddeeris & Weisbrod (1998) to understand the reasons of a conversion one has to understand what changed in the context and environment of the NPO.
- II. Reasons for conversion: The literature provides numerous reasons why conversion may occur (see chapter 2.4). However, it is important to have them

<sup>9</sup> Own representation.

confirmed by experts and to elaborate on them.

- III. Understanding of the decision-making process: Nothing is known about how the decision is made and what are key steps. Therefore, the decision-making process is a black box with the input being reasons to convert and the output being the decision to convert into a specific for-profit structure.
- IV. Lessons learned from the transformation process: The challenges identified (see chapter 2.5) give a first glimpse of what they might be for a conversion. Hence, they need to be confirmed and complemented by possible new challenges. These act as a base for KSFs and lessons learned.

To conclude, the four areas translate into the following research questions:

1. What kind of change in the context occurred that led to reasons for conversion?
2. What are the reasons for conversion in each specific case?
3. What is the decision-making process like and what are key steps?
4. What can be learned from the transformation process?

Before using these four research questions as the basic outline for the expert interviews, the methodology and scientific approach will be explained in the following.

### **3 Methodology**

The methodology is based on a two-step research process of literature theory and applied practice. First, the key concepts of the conversion from nonprofit to for-profit were clarified and available knowledge to describe the conversion process was discovered in the literature. Based on these insights research gaps were identified. The second step involves expert interviews as a qualitative research method that serves an exploratory and descriptive purpose. Thereby, based on six criteria for the expert selection (see Appendix 3) suitable companies (see Appendix 4) and experts were

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identified through research and directly contacted via LinkedIn. Next, the interview method's key characteristics (see Appendix 5) for this work project had to be defined based on social research practices (Babbie 2013). Then, the four research areas and questions from chapter 2.6 were further transformed into a questionnaire (see Appendix 6) based on the findings from the literature review. This questionnaire was used for the expert interviews that were recorded with the consent of the interview partners and transcribed after. The transcripts<sup>10</sup> were then used to cluster and compare the information according to the four research areas in preparation of the interview analysis. To create value for social entrepreneurs and nonprofit managers who might face a conversion, all information was condensed and the essence was used to create a practical guideline for how to make a decision and how to overcome challenges related to the conversion.

Although the initial objective of this work project was to fill the gaps with the expertise obtained through an exploratory survey with a sample of ten interviewees or more, it became clear during the research for suitable companies that a multiple case study approach is the better choice to come up with valuable information. This is mainly because only a few suitable companies could be identified due to the selection criteria. In addition, the interview length had to be extensive (around 60 minutes) to cover all research areas in required depths and detail, which leads to less availability from an interviewee perspective. Furthermore, to get the required information it was crucial to talk to high-level experts who took part to a major degree in the conversion, which also contributes to less availability. The decision led to first hand experience and insights based on four exploratory and descriptive expert interviews with top managers (from

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<sup>10</sup> The transcripts of the interviews can be found in the External Appendix on CD.

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the companies Gentera (Banco Compartamos), Mobis Transportation Alternatives, Inc. / Bikestation, TRUSTe and World Centric) who experienced a conversion process. The four experts agreed on a 60 minute Skype call and were interviewed between February 26 and April 14 of 2015.

## **4 Expert Interviews**

In chapter 4 the information is based on the expert interviews if not otherwise stated.

### **4.1 Case Descriptions**

To get a better understanding of the context of the interview partners, the following gives a brief introduction of their companies and function:

- Fran Maier: CEO of TRUSTe from 2001-2012. TRUSTe was founded in 1997 as a US industry association with the mission to come up with Internet privacy standards. The nonprofit started developing and selling an Internet trust mark certificate to companies who live up to the privacy standards and converted to a for-profit in 2008. Since then the company grew from six to more than 25 M USD in revenue and became a leading firm in data privacy management (TRUSTe 2015).
- Aseem Das: Co-Founder and Executive Director of World Centric. World Centric started in 2004 as a US nonprofit with educational purposes by showing documentaries and films. Over time it started with online retailing of Fair-trade coffee and biodegradable cutlery. In 2009 the company converted to for-profit status and shortly after became a B-Corporation by certificate and as a legal entity (World Centric 2015).
- Andrea White-Kjoss: Co-Founder and CEO of Mobis Transportation Alternatives,

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Inc./Bikestation<sup>11</sup>. The nonprofit Bikestation was founded in 1996 in the US with the purpose of building biking facilities for more convenient, affordable and environmental friendly transit. Users of bikestations pay a member fee but the company also consults governmental transit agencies. In 2008 Bikestation converted in the sense of linking the newly founded for-profit Mobis Transportation with the former nonprofit through an intra-organizational contract. It also became a certified B-Corporation (Bikestation 2015, Mobis Transportation Alternatives, Inc. Company - Bikestation 2015).

- Javier Fernando Cueto: Innovation and New Businesses Executive Officer of Genera (Banco Compartamos). Banco Compartamos was founded in 1990 in Mexico as a microfinance nonprofit with the mission to eradicate financial exclusion and converted to a for-profit in 2000. Since then it started to grow to the largest microfinance bank in Latin America also offering microinsurances and other products. In 2006 the commercial banking licence was obtained followed by the company's IPO in 2007. Today, Compartamos is the microfinance bank subsidiary of the holding group Genera and operating in Peru (Compartamos Financiera), Guatemala (Compartamos S.A.) and Mexico (Compartamos Banco) (Genera 2015).

## 4.2 Interview Analysis

In the following, the interview data will be examined according to the four research areas. However, there will be an explicit reference to questions if necessary. The focus lays on illustrating similarities and differences of each conversion case. Hence, information will be clustered and/or highlighted accordingly. World Centric's story is different and thereby, will be mentioned mostly separately from the sub-group of

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<sup>11</sup> For reasons of simplicity the hybrid organization Mobis Transportation Alternatives, Inc./Bikestation will be called Bikestation.



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TRUSTe, Bikestation and Gentera whose cases are more comparable with each other. The difference is mainly attributed to the reasons of the conversion as well as the change of the business model. TRUSTe, Bikestation and Gentera converted with the motivation to increase impact while their business model stayed the same. World Centric, however, changed its business model fundamentally before the conversion and then converted to become donor independent as well as due to operational bottlenecks.

#### I. Historical development of the NPO until conversion

Reasons why the nonprofit form was chosen initially vary. As an industry association TRUSTe had to combine companies under the same tent that would otherwise compete. Moreover, its founders believed to be less commercially influenced by investors or by the companies they were certifying. For World Centric the nonprofit form made sense to institutionalize its educational purpose. Bikestation used the nonprofit as a way to get easier access to important entities and partners while for Gentera it was the easiest way to get access to volunteers and donations to start the business without any seed capital. Both thereby lowered the risk of operations involved in funding a business.

The social mission of each company was described in the case description in chapter 4.1. Concerning the delivery of the social mission the years before the conversion TRUSTe and Gentera went on a similar route. They both managed to grow significantly while being funded not only by donations but also by services they provided. On the contrary, Bikestation was also mostly self-funded but was growing at a very slow pace and wasn't reaching the critical mass required to have an impact on transit infrastructure. World Centric's founder was living off savings while delivering its educational mission on a small scale without any significant growth. After two years without a salary he changed the business model to become an online retailer of Fair-

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trade coffee and later on of compostable cutlery. This business was then growing and providing income while doing good.

## II. Reasons for conversion

TRUSTe, Bikestation and Gentera had very similar reasons to convert. They were all limited in their funding (lack of resources), which wouldn't allow them to follow their growth strategy to further increase their impact. Hence, the social mission was the reason for the conversion. Plus, their already existing commercial business models needed little adjustment.

With a background in start-ups TRUSTe's new CEO had a more professional attitude and six-folded the NPO's revenue within five years before converting. She realized the brand's value to its clients and developed a use case of an international expansion into smaller businesses with a more technology and distribution enabled approach and also addressing new privacy issues with new products. However, there was no access to sponsorships or government grants as an industry association and without capital there was no possibility to invest in front of problems to react to the threat of going to be marginalised. Another reason was the CEO's personal interest in ownership stakes to get compensated for the hard work.

Bikestation was not able to access capital since the service was not perceived as "sexy" to donors. To escape the slow growth without ever achieving real impact the NPO felt the need for investment from the private market. In addition, the organization's board wanted to make a greater impact and sensed an opportunity to follow a growth strategy since its business model was already almost entirely commercial. Furthermore, the management had contact with the impact investment environment what gave further encouragement to convert.

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Gentera was very successful and seven years after the foundation the NPO was operationally and financially viable with funding from the World Bank, friends, family and through providing its microfinance service. Due to this success the organization could not access more capital from donations. Since organic growth through reinvesting own profits would have lead to a very slow growth rate, the only way to follow its ambitious growth strategy (reach the most amount of people in the shortest amount of time) was by getting capital from commercial banks as a for-profit.

World Centric's founder wanted to live from the business in a self-sustainable way and not competing for funds or being dependent from donors. Since the business model had changed over time from providing education to online retailing the growing business required money, e.g., for working capital, which was impossible to access from banks as a nonprofit (not legally allowed in the US).

### III. Understanding of the decision-making process

Based on the reasons for conversion TRUSTe, Bikestation and Gentera had the same goal in mind: Increase impact. Hence, the social mission did influence the decision-making fully. All three organizations approached the decision-making process similar and followed a two-step method. First, the responsible managers and board members talked about the current need, the future growth and impact. In addition, they all had external opinions from experienced mentors (Gentera), nonprofit consultants (TRUSTe) or impact investors (Bikestation). Second, the decision which legal form to take was discussed. TRUSTe therefore consulted nonprofit attorneys while Gentera underlined the importance of the legal framework being determined by the strategy.

In regards of evaluation criteria in the decision-making process the experts highlighted the following questions sorted by priority: 1. What is the social value? 2. Is it possible

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to incorporate the mission in the for-profit? 3. Is the business model investment ready/investable? 4. Is the conversion legal? 5. What do customers think about the conversion? 6. What is the economic value?

Bikestation and Genera did not discuss alternative decision outcomes. The expert of TRUSTe said that it was looked into becoming acquired by competitors but the feeling was they were too small. The option of becoming a B-Corporation was known but was not considered because they thought they wouldn't get the investment, as it was neither well known nor well regarded back then in 2008.

In the end all three company experts not only felt like they made a free decision to convert but also like they were pioneers in the field of nonprofit to for-profit conversion. Especially Bikestation mentioned difficulties in finding information whereas Genera had contact with BancoSol in Bolivia (the first microfinance nonprofit in the world that converted to for-profit) but still had to pioneer to do the same in Mexico.

World Centric's goal was to live from the business without fundraising and still doing good. The decision-making process was mainly about reflecting on questions like: As a for-profit are we all about making money? What is the distinction between nonprofit and for-profit in terms of what they do? Is it possible to execute the social mission while being a for-profit? If yes, how?

If it wasn't clear that World Centric could execute its social mission and do social good the NPO would have not decided to convert. The company described itself as mix of being a 60% adaptor and a 40% pioneer mainly because it adapted to what it already was (online retailer) although pioneering is happening in terms of the business model and internal processes.

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#### IV. Lessons learned from the transformation process

The biggest challenge according to the experts of Gentera and Bikestation is the legal work of the conversion. When Gentera converted in 2000 it was never done before in Mexico. Bikestation perceived the legal incorporation of the social mission as difficult. World Centric however, experienced an easy legal conversion simply by hiring a lawyer who was submitting the documents. This can be explained due to the fact that no assets were ever accumulated through the nonprofit. Bikestation also mentioned that a lot of time was lost in the process (almost one year). Furthermore, the company described the challenge of dealing with investor expectations that created an inflection point due to a shift in the balance of power that wasn't immediately apparent in the decision-making process. TRUSTe mentioned the perceived challenge of employees not adapting to the new for-profit situation, which in the end turned out to be wrong.

Gentera named four lessons learned: The transformation was thought to be easier, the company's employees had to change themselves to a more corporate based thinking and it was learned that it is helpful to be challenged by being responsible for others (shareholders, investors, etc.) to provide better results. Lastly, more thought should have put into proper transformation planning.

TRUSTe namely learned that what brings the most impact is the most important thing to do and that there is no way to increase impact undercapitalised.

World Centric's lesson learned was that its business impact is easier to measure than its educational impact and that the business impact will be bigger ultimately if the business continues to grow. In addition, the conversion was seen as a good thing because it made the company more focused. Regarding the realisation the expert mentioned that it is very hard as a nonprofit to grow bigger than 3-5 M in the US since fundraising becomes

more difficult. And because both organizational types, NPO and FPO, have to raise funds it is easier doing so as a for-profit.

The experts (excluding World Centric) stated several success factors (Table 1).

Table 1: Success factors mentioned in expert interviews<sup>12</sup>

Success factors
<ul style="list-style-type: none"> <li>• Have the right business model (TRUSTe)</li> <li>• Take emotions aside since NPO and FPO distinctions are mainly about tax law (TRUSTe)</li> <li>• Have a solid business plan (Bikestation)</li> <li>• Find the right investors (Bikestation)</li> <li>• Have good timing (Bikestation)</li> <li>• Don't underestimate the time the conversion takes (Gentera)</li> <li>• Be prepared to enter the corporate world (Gentera)</li> <li>• Make use of change management (Gentera)</li> <li>• Change without the clients feeling any change (Gentera)</li> <li>• Get constantly reminded of the social mission by implementing a nonprofit as the biggest shareholder (Gentera)</li> </ul>

The last question to the experts was whether the social mission has changed due to the conversion. TRUSTe, Bikestation and Gentera said no. World Centric said yes, there was a mission drift from serving an educational purpose only towards being an online retailer selling compostable products. However, World Centric changed its original mission but is now compensating its purely commercial approach through donating at least 25% of the company's revenue to social purposes.

## 5 Implications and Value Creation

In the following the most important results (based on literature review and expert interviews) will be described concerning the three examined areas in the context of conversion: Reasons for conversion, decision-making process and key success factors for the transformation process.

### 5.1 Reasons for Conversion

First, it is important to know and understand the reasons for conversion and how they are influenced. As explained in chapter 2.4 NPOs have their advantages in regards to

<sup>12</sup> Own representation based on expert interview.

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tax benefits as well as access to resources like governmental grants, donations and volunteers. But once these advantages fade over time due to external or internal changes and the legal requirements hold the organization back, it might be time to consider a conversion. A FPO brings advantages in regards of efficiency, more time for value creation, management compensation and greater access to equity capital. The latter is attributable to the many possible investors of the private market as compared to limited grant and donation sources. Whatever holds the organization back from creating impact due to an external change in the context or internal changes, e.g., strategy should be considered the most important and should be overcome by adapting the organizational model ultimately resulting in a change of the legal structure (see Appendix 2 for a list of possible changes). Thus, it might make sense to convert for reasons that were identified in the literature review. The experts also confirmed this.

The knowledge about these reasons may help to clarify whether or not there is the necessity for a conversion in the first place.

## **5.2 Decision-Making**

Once potential reasons for a conversion are known the following decision-making approach (derived and based on the experts input) creates new scientific knowledge and may help to come up with the right choices and legal structure.

1. Talk with the board and managers about the future of the business and clarify the need of the conversion (e.g., through creating a use case and going through reasons), the organizations strategy (e.g., with a strategic planning process), the social mission and the impact that all may contribute to define legal alternatives and the goal of the decision-making process.
2. Seek external expert advice (e.g., nonprofit and for-profit attorneys, nonprofit

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consultants, impact investors) and look for similar cases and best practice to complement the information and data obtained so far. Appendix 4 shows the list of converted nonprofits that was used to find experts. These companies may serve as additional case examples.

3. Use the decision matrix (Table 2) that helps making the conversion choice and choosing a legal form according to what fits best to the organization's strategy. To better illustrate the use of the matrix an exemplary evaluation was made from the perspective of a notional NPO, which is explained in the following:

- First, possible legal structures that shall be evaluated are written in the upper right (in this case LLC, L3C and B-Corp).
- Second, KO criteria are considered. The first three criteria are general and are not specifically applied to the potential legal structures. In this example, regulators allow the conversion and the NPOs' business model is investable, i.e., it is considered suitable and to be living up to investors' expectations (e.g., regarding ROI, commercial viability, etc.), which will later allow equity funding. Furthermore, the NPO is investment ready since a proper business plan (including growth plan, exit strategy, etc.) was prepared, which will be necessary to pitch in front of investors. Last, it is reviewed whether it is possible to incorporate the social mission in the for-profit structure. In this example it is not considered possible for the LLC and it is withdrawn from the further evaluation.
- Third, seven evaluation criteria are assessed. To start with, the NPO has to weight them according to its own judgement and importance. For example, in this case the impact on social value created through the conversion is seen very



important and, hence, it is weighted with 30% of a total of 100%. The evaluation of each criterion is made according to a 0 to 10 scale, which is explained next to it. The only exception is criterion 5, where the scale goes from -10 to 10.

- When all criteria are evaluated based on the numerical rating the Total Points in the lower right are calculated according to the weighting. The highest score equals the highest rank and should be considered the best option (in this example the L3C).

It is important to mention that this matrix should be individualised and may be extended according to the corresponding needs and strategy of the case of application.

Table 2: Decision matrix (with hypothetical example)<sup>13</sup>

Legal alternatives		LLC	L3C	B-Corp
<b>KO criteria</b>				
1. Is the conversion legal? Do regulators allow it?			✓	
2. Is the business model investable?			✓	
3. Is the business investment ready (i.e. proper business plan)?			✓	
4. Is it possible to incorporate the social mission in the for-profit structure?		✗	✓	✓
<b>Evaluation criteria</b>	<b>100%</b>			
1. Impact on social value (very high = 10, very low = 0)	30%		8	7
2. Customers' perceived change (no change = 10, change entirely = 0)	15%		7	6
3. Credibility of the business after conversion (very credible = 10, not credible = 0)	15%		6	7
4. Change of service or product (no change = 10, change entirely = 0)	10%		6	8
5. Impact on stakeholders after the conversion (very positive impact = 10, neutral impact = 0, very negative impact = -10)	10%		10	-2
6. Change management necessity (low = 10, high = 0)	10%		0	10
7. Impact on economic value (very high = 10, very low = 0)	10%		8	3
<b>Total Points</b>		<b>0</b>	<b>6,75</b>	<b>5,95</b>
<b>Rank</b>		<b>3</b>	<b>1</b>	<b>2</b>

### 5.3 Overcoming Challenges: Key Success Factors

Once the decision is made to convert to a certain legal form the transformation process begins. Based on the literature research and the interviews (lessons learned and stated success factors) the following list combines the most important key success factors for the transformation:

1. Work out a business model that is suited as a for-profit (in the best case only minor adaptations are required) and create a solid business plan. Align the latter with the

<sup>13</sup> Own representation based on expert interview.

strategic plan to be prepared to convince traditional investors that are less used to the nonprofit environment. Thereby, the challenge of financing may be overcome.<sup>14</sup>

2. Don't underestimate the time and complexity it takes to convert.<sup>15</sup>
3. Be prepared to enter the corporate world in regards of business processes, record keeping and mindset as well as apply proper planning.<sup>16</sup>
4. Separate emotions and beliefs about nonprofits and for-profits, i.e., it is possible to do good and have impact being a for-profit. The distinction is minor and mainly about tax law<sup>17</sup>. Albeit both organization types have different funding sources<sup>18</sup>, getting funded makes an organization always dependent, in one way or another. But for-profits have greater access to capital and can concentrate more on the actual value creation than on fundraising, which can be a big advantage.
5. Consult legal experts (e.g., nonprofit and for-profit attorneys). This is very important since the legal process can be very demanding.<sup>19</sup> If the NPO has assigned a certain value to it a forensic accounting firm has to estimate the value. If not, the legal process is relatively easy.
6. Make sure that the social mission will not be forgotten. To get constantly reminded organizations that open their capital can implement a nonprofit as the largest shareholder. Smaller companies can use own company goals and, e.g., a B-Corporation certificate to ensure social alignment.

<sup>14</sup> The challenge of financing is mentioned by Battiliana et al. (2012) in chapter 2.5 and also the experts.

<sup>15</sup> Bikestation said they lost a year due to the road show to get investors. Gentera highlighted as well that the process took longer than expected and they thought it was easier.

<sup>16</sup> Gentera mentioned the importance of proper planning. Even if the organization is not operating in the microfinance sector Ledgerwood (2006) might provide helpful guidance.

<sup>17</sup> This is advice from TRUSTes' expert. Since the company is operating in the US market the distinction may only apply to the US tax law.

<sup>18</sup> A NPO has limited access to funding through grants, subsidies or private donations whereas a FPO has easier and less work intensive access to capital from the private markets.

<sup>19</sup> That was explicitly mentioned by the experts of Bikestation, Gentera and TRUSTe as well as Battiliana et al. (2012) and Goddeeris & Weisbrod (1998).

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7. Identify the right investors, i.e., it is important finding impact investment investors who believe in the mission<sup>20</sup>. In this context, be aware of the challenge of having an inflection point once investors enter the board. This is due to a shift in balance of power that may arise since the capital vote is stronger not in an absolute but in a structural sense.<sup>21</sup>
  8. Consider a change management process to allow the employees to get familiar with the new legal structure and its implications. This is especially important for bigger companies. In this context the challenge of an imbalance within organizational culture might be possible to overcome.<sup>22</sup>
  9. Nothing should feel different for the company's beneficiaries or customers. Hence, it is important to ensure a seamless transformation without them feeling any negative change.
  10. Align the social mission with the goal of growth by making "the increase of social impact" one of the essentials of the mission statement. Thereby, it is ensured that social mission and commercial growth are interchangeably linked and complement each other. And even if growth is not the primary trigger of thinking about a conversion it is possible that a for-profit can still contribute to social good by donating a big part of the revenue to NPOs.<sup>23</sup> If the for-profit is set up accordingly, the organization doesn't have to compromise on the social mission. However, when priority is given to profit seeking mission drift may arise.<sup>24</sup>

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<sup>20</sup> Social entrepreneur Saul Garlick highlights this (Chhabra 2013a).

<sup>21</sup> This was especially mentioned by Bikestation.

<sup>22</sup> Mentioned by Battiliana et al. (2012). Compare with chapter 2.5.

<sup>23</sup> World Centric donated in some years up to 90% of the revenue (World Centric 2015).

<sup>24</sup> Mentioned by Battiliana et al. (2012). Compare with chapter 2.5.

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## 6 Conclusion

In chapter 2 the literature research introduced the key elements of the nonprofit to for-profit conversion as well as gave a brief overview of conversion history, its reasons and challenges. The identified research gap was used to build the research questions for this work project. Chapter 3 explained the methodology, a two-step research approach, combining theory and applied practice, i.e., expert interviews. In chapter 4 the four cases of the interviewees and their companies were briefly described and then analysed according to the research questions. Chapter 5 was then used to condense the obtained knowledge from theory and practice to create social and economic value. The value was delivered in form of a hands-on guideline for social entrepreneurs and NPO managers that might face a conversion and want to overcome its challenges. Apart from the identified KSFs, a decision matrix was developed that allows assessing which legal structure is best suited for the strategy of the future for-profit.

The major limiting factor was the small sample. With only four interviewees from two different countries (USA and Mexico), generalisation of results is called into question. In addition, conversion literature is relatively old (most articles originate from around 2000 in the context of the US Health Care market conversion) and doesn't provide up to date information. The recent literature is more about hybrid business structures, which confirms the trend that can be seen in the US where B-Corporations are becoming a legal entity (B-Lab 2015). This might increase the number of nonprofits converting not to a purely for-profit legal form but to a hybrid B-Corporation. In this context, the guideline could be used and tested for its applicability. Another field of exploration are other regional markets like Europe, e.g., by identifying current legal reforms that allow for a similar application of the guidelines.

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## 8 Appendices

### Appendix 1: Advantages of NPOs and FPOs<sup>25</sup>

Advantages of NPOs	Advantages of FPOs
<ul style="list-style-type: none"> <li>• Tax benefits</li> <li>• Social legitimacy and goodwill that attract               <ul style="list-style-type: none"> <li>• grants,</li> <li>• donations,</li> <li>• volunteers,</li> <li>• pro bono professionals</li> <li>• and other free/inexpensive resources</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Efficiency i.e. having less problems with the following:               <ul style="list-style-type: none"> <li>• Insufficiency (scarce resources or no optimal allocation)</li> <li>• Particularism (supply only for specific groups, too much or not for everyone)</li> <li>• Paternalism (resource donor are interested in type of supply)</li> <li>• Amateurism (amateurs decide over the process or are part of it)</li> </ul> </li> <li>• Greater access to capital</li> <li>• Private compensation/benefits of managers</li> <li>• More time for value creation</li> </ul>

<sup>25</sup> Own representation based on Battiliana et al. (2012), Chhabra (2013a), Goddeeris & Weisbrod (1998, 2006); Thieme & Winkelhake (2012).

## Appendix 2: Areas of external/internal change that may lead to a conversion<sup>26</sup>

External changes (change in constraints) in the following areas:	Internal changes in the following areas:
<u>Market:</u> <ul style="list-style-type: none"> <li>• Demand conditions (ability to pay, number of customers)</li> <li>• Supply of labour or other resources (volunteers, availability of private donations and government grants and contracts)</li> </ul> <u>Legal system:</u> <ul style="list-style-type: none"> <li>• Tax liability on income, real property, sales and the like</li> <li>• Access to tax-deductible contributions</li> <li>• Access to equity capital</li> <li>• Restrictions on “profit” distributions</li> <li>• Availability of government grants and subsidized loans</li> <li>• Regulatory requirements regarding product offerings, pricing, and access</li> </ul>	<u>Organizational/Managerial goals:</u> <ul style="list-style-type: none"> <li>• Growth strategy (scaling requires more capital)</li> <li>• Inability to get enough resources (donation or volunteers)</li> <li>• Private benefits or personal financial gain</li> <li>• More efficiency wanted (professionalism)</li> <li>• Change of board members or responsables may change managerial goals</li> <li>• Change in business model (new department, Robin Hood model, etc.)</li> </ul> <u>Operational Bottlenecks:</u> <ul style="list-style-type: none"> <li>• Capital requirements due to</li> <li>• Working Capital</li> <li>• CAPEX</li> </ul>

## Appendix 3: Six Criteria for Expert Selection

1. The expert had to or has to work for a company that went through a nonprofit to for-profit conversion according to the definition and six possible types from Goddeeris & Weisbrod (1998) (see chapter 2.2).
2. The expert had to be responsible for the conversion process or taken part in at management level.
3. The company’s conversion had to be successful<sup>27</sup>, i.e., the company has to be still on the market and ideally growing since the conversion.
4. The former NPO has converted to a for-profit without any governmental incentive before, during or after the conversion to be aligned with the definition of a nonprofit of United Nations (2003) as described in chapter 2.1. However, the NPO might have received governmental grants and the government might have been a client of it.
5. Historical industry conversions within the microfinance sector should not solely

<sup>26</sup> Own representation based on Goddeeris & Weisbrod (1998), Thieme & Winkelhake (2012).

<sup>27</sup> See Oxford Dictionary (2015): The definition of successful is accomplishing a desired aim or result.



contribute to the research since the goal is to find information across industries. Thereby only major players were considered.

6. The conversion had to be not before the year 2000 to have access to relatively recent expert memory and context.

#### Appendix 4: Company list based on own research<sup>28</sup>

Name	Country	Industry	Year of foundation	Year of conversion	Fullfills selection criteria
Embrace / Embrace Innovation	USA	Medical Devices	2008	2012	yes
Mozilla Foundation / Corporation	USA	Internet Software	2003	2005	yes
Think Impact	South Africa	Education	2002	2011	yes
World Centric	USA	Education	2004	2009	yes
Mobis Transportation Alternatives, Inc. / Bikestation	USA	Bike Infrastructure	1996	2008	yes
Story Pirates	USA	Education	2003	n/a	yes
Genera (Banco Compartamos)	Mexico	Microfinance/Banking	1990	2000	yes
Evergreen Lodge	USA	Hospitality	1921	2001	yes
TRUSTe	USA	Internet Trustmark	1997	2008	yes
SKS Microfinance	India	Microfinance/Banking	1997	2005	yes
BancoSol	Bolivia	Microfinance/Banking	1986	1992	no
Adiva	France	Networking	2009	2010	no
Cirque du Soleil	Canada	Entertainment	1984	1985	no

#### Appendix 5: Key characteristics of the interview method

- Degrees of freedom of interviewee: An open degree of freedom (vs. closed) allows for a more holistic and comprehensive view as well as better in depths understanding of the conversion process.
- Degrees of freedom of interviewer: A partly structured approach allows covering all the research areas' questions about the conversion while being flexible in regard of the interviewee's open degree of freedom.
- Type of analysis: The analysis of the expert interviews will be qualitative which allows for interpretation (vs. quantitative that focuses on hard facts and numbers).
- Type of question: Direct questions are best suited to get an understanding of the conversion process and allow honest communication.
- Type of communication: All interviews are held via Skype.

<sup>28</sup> See amongst Internet research Battiliana et al. (2012), Bloomberg (2007), Chen (2013), Chhabra (2013b), Khalili (2010), Lapowsky (2011), Tozzi (2009).

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## Appendix 6: The questionnaire

### I. Historical development of the NPO until conversion

- a. Why was NPO chosen initially? What were the reasons?
- b. What was the company's initial social mission?
- c. Was the venture successfully delivering its social mission?

### II. Reasons for conversion

- a. What has changed since the foundation to make the NPO form less desirable?
- b. Why did you start thinking about a conversion?

### III. Understanding the decision-making process

- a. How did you approach the decision-making process?
- b. What were the key steps towards a decision-making process?
- c. What was your goal? E.g., getting access to capital while avoiding mission drift
- d. How did the social mission impact the decisions process?
- e. What were your criteria for evaluation? How important was each?
- f. What were your alternatives/possible decision outcomes?
- g. Did you feel you were forced to convert due to specific external/internal constraints or was it a free decision?
- h. Would you describe the company's role more like an "Adaptor" (adapted your structure to the environment) or a "Pioneer" (no outside pressure, e.g., changing the business model)?

### IV. Lessons learned from the transformation process

- a. Which difficulties and challenges did you encounter?
- b. What are your lessons learned? ((Non-)success factors)
- c. What is the company's social mission now? Has it changed?